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# **The Effect of Legal Systems and Accounting Conservatism on Corporate Governance: The U.S. versus the U.K.(A Comparative Analysis)**

Narayanan, Supreena

Stockholm School of Economics

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**The Effect of Legal Systems and Accounting Conservatism on Corporate Governance: The U.S. versus the U.K.(A Comparative Analysis)**

BY

**SUPREENA NARAYANAN**

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**Institute Of International Business(IIB)  
Stockholm School of Economics  
P.O Box 6501  
SE-113 83 Stockholm  
Sweden**

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**JUNE 2006**

**BONAFIDE CERTIFICATE**

This is to certify that the thesis titled ‘The Effect of Legal Systems and Accounting Conservatism on Corporate Governance: The U.S. versus the U.K.’ is the bonafide work of Miss Supreena Narayanan who carried out research under the supervision of Dr Andrei Simonov and Dr Patrick Regner. Certified further, that to the best of my knowledge, the work reported therein does not form part of any other thesis or dissertation on the basis of which a degree or award was conferred on an earlier occasion on this or any other candidate.

**Dr Patrick Regner,  
Dean,  
Institute of International Business,  
Stockholm School of Economics  
P.O Box 6501  
SE-113 83 Stockholm  
Sweden  
Email: patrick.regner@hhs.se**

**Dr Andrei Simonov  
Associate Professor  
Department of Finance  
Stockholm School of Economics  
P.O Box 6501  
SE-113 83 Stockholm  
Sweden  
Email: Andrei.Simonov@hhs.se**

**Dr Lin Lerpold,  
Assistant Professor,  
Institute of International Business,  
Stockholm School of Economics  
P.O Box 6501  
SE-113 83 Stockholm  
Sweden  
Email: lin.lerpold@hhs.se**

## **Abstract**

Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments. This paper analyses the effects of legal systems and accounting conservatism on corporate governance.

The U.K. and American corporate governance perspective, there have fundamentally been the same goals with respect to strengthening corporate governance. In comparison to the U.S. vs the U.K., the value of independent directors is emphasized in the recommendations of Derek Higgs regarding corporate governance, building on the earlier work of the Cadbury Commission.

In the U.S. it is the responsibility of the States and the stock exchanges to determine their corporate governance requirements.

In the U.K. it is the responsibility of the Security Exchange Commission to overlook adherence to corporate governance regulations whereas it is the duty of the Sarbanes Oxley act to overlook the corporate governance rules and regulations.

Theory indicates that accounting conservatism is important to establish an efficient corporate governance system in both the U.S and the UK

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## **1. Corporate Governance (defined)**

Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments<sup>1</sup>. Most advanced market economies attempted to solve the problem of corporate governance to the extent that they have assured the flows of enormous amounts of capital to firms, and actual repatriation of profits to the providers of finance. But that does not imply that they have solved the corporate governance problem perfectly, or that the corporate governance mechanisms cannot be improved. Corporate Governance mechanisms are economic and legal mechanism that can be altered through the political process. Corporate Governance is a straightforward agency perspective sometimes referred to as separation of ownership and control.

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<sup>1</sup> Shleifer, Andrei and Robert Vishny (1997), "A Survey of Corporate Governance", Journal of Finance, Vol 52

## **1.1 Corporate Governance in Finance**

Corporate Governance influences the efficiency of firm production at the corporate level, so that the effectiveness of a nation's corporate governance system shapes economic performance at a country level<sup>2</sup>. Standard agency theory defines the corporate governance problem in terms of how equity and debt holders influence managers to act in the best interests of the providers of capital. To the extent that shareholders and creditors induce managers to maximize firm value, this will improve the efficiency with which firms allocate resources. These mechanisms, however, do not work well around the world. Small investors have a difficult time exercising corporate governance because of informational asymmetries and poor legal, bankruptcy and regulatory systems. If the world is to rely on banks and other financial intermediaries-to exert effective corporate governance, then the managers of financial institutions must themselves face sound corporate governance. If bank managers face sound incentives, they will be more likely to allocate capital efficiently and then implement effective corporate governance over the firms in which they invest. If bank managers however have enormous discretion to act in their own interest rather than the interests of the banks' equity and debt holders, then this will affect corporate governance. In particular, banks will allocate capital less efficiently and bank managers may actually induce firm managers to behave in ways that favor the interests of bank managers and firms but overall hurt firm performance. Thus, the corporate governance of banks and other financial intermediaries is crucial for shaping capital allocation at the firm level; and at the country level. Nevertheless, the financial sector has generally received far less attention to the corporate governance literature than

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<sup>2</sup> Caprio, Gerard Jr. And Ross Levine, "Corporate Governance in Finance: Concepts and International Observations" (2002)



seems warranted by their central role in a nations corporate governance system. How do the suppliers of capital influence the managers to act in best interest of capitalists?

First, governments construct the basic legal system underpinning corporate governance. Second, governments may influence the flow of corporate finance by restricting corporate activities and insuring corporate finance in the case of banks and occasionally other intermediaries.

## **1.2 Problems of Corporate Governance in Finance**

In particular, we examine three interrelated characteristics of financial intermediaries and how these traits affect corporate governance. First, banks and other intermediaries are more opaque which fundamentally affects the agency problem. Due to a greater information asymmetries between insiders and outside investors in banking, it is 1) more difficult for equity and debt holders to monitor managers and use incentive contracts, 2) easier for managers and large investors to exploit the benefits of private control, rather than maximize value 3) unlikely that potential outside bidders with poor information will generate a sufficiently effective takeover threat to improve governance substantially and 4) likely that a more monopolistic sector will ensue and will generate less corporate governance through product market competition, compared with an industry with less informational asymmetries. Second banks, like most intermediaries, are heavily regulated and this frequently impedes natural corporate governance mechanisms. For instance i) deposit insurance reduces monitoring by insured depositors, reduces the desirability of banks to raise capital from large uninsured creditors with incentives to monitor, and increases incentives for shifting bank assets to more risky investments) regulatory restrictions on the concentration of ownership interfere with one of the main mechanisms for exerting corporate governance around the world: concentrated ownership, iii) regulatory restrictions on entry takeovers and bank activities reduce competition which reduce market pressures on managers to reduce profits and 1v) bank regulators and supervisors frequently have their own incentives in influencing bank managers that do not coincide with value maximization. Finally, government ownership of banks fundamentally alters the corporate governance equation. Since state ownership of banks remains large in many countries, this makes corporate governance of the banking industry very different from other countries.

### **1.3 Strategy for improving Corporate Governance**

<sup>3</sup>Existing research shows that countries in which the government supports the utility of private sector entities to monitor banks, permits banks to engage in a wide range of activities, in banking. As a first step, it is critical that governments recognize and curb any of their own behaviors that thwarts the private sectors' ability and incentive to monitor banks. Thus, for example, in countries in which government ownership is [pronounced, private sector monitoring cannot be expected and competitive forces clearly are blocked. Moreover, as argued above, government supervision of government banks also cannot be expected to be through and independent as we observe in India. In these cases, embarking on a program to reduce government ownership where it is pronounced would seem to be essential. Without this step it is difficult to conceive of the success of other efforts to ameliorate the governance problem. Countries with blanket deposit insurance or extremely generous deposit insurance coverage (certainly the levels of 10 to 15 times per capita GDP are found in very low income countries) also are sure to be those in which private sector monitoring is virtually non existent. Reducing such coverage to much lower levels also would be essential in order to enhance private sector monitoring. A second step in improving governance in banking involves directly reducing the opacity of banks by improving the flow of information. Although transparency of banking information in emerging markets is receiving increased attention in the wake of the East Asian Crisis (and perhaps more so in the aftermath of the Enron collapse), the likely reinforcement of opacity by existing ownership patterns in emerging markets suggests that this task is even more important and yet more difficult than has been recognized. In effect, authorities will need to engage in the unpopular task of shaking up cozy relationships among powerful interest groups in their society. This task is not as simple as superficial adherence to international standards; rather, it is a process that will require

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<sup>3</sup> Caprio, Gerard Jr. And Ross Levine, "Corporate Governance in Finance: Concepts and International Observations" (2002)

sustained commitment over a period of time in order to effect. In addition to much greater attention to improving accounting and auditing, improvements to credit information will facilitate the expansion of banking by those interested in providing finance to groups that were previously excluded. Enhancing corporate finance reporting in the media, and education as to the importance of this issue in a wide swath of civil society, will help make a lasting contribution to better corporate governance. This is not easy: the same family groups that control banks may also control the media, so broader antitrust activity may be necessary in order to make this work. Moreover, it is worth stressing again that these changes will not happen to the extent that government underwrite risk. Third, although better information may indirectly enhance the contestability of the banking market and invigorate the market for corporate control in banking, opening to foreign banks offers a direct mechanism for creating competitive pressures in banking. It was not so much the presence of foreign banks as the contestability of markets (associated with relative openness to foreign entry) that contributed to the development and stability of emerging market banking. Foreign banks, and indeed foreign entry in other markets will serve to increase the competitiveness of the economy in general and lessen the reliance on family or conglomerate relationships. Increased foreign presence in emerging market banking has the attractive benefit of improving access to credit, even by small and medium sized enterprises. The resulting increase in competition in the economy can pay dividends in the long-term to the corporate governance problems discussed here. Clearly the same should apply to foreign competition in insurance and pension management. Fourth and most importantly the potential monitors of banks-owners, markets and supervisors-need clear and strong incentives to do their jobs well. As stressed above, the legal and bankruptcy systems do not operate well in many countries. Thus, bank managers can control banks with little to fear from outside investors, or even from bankruptcy as is clearly evident from Japan's ten-year banking crisis. Owners, particularly controlling shareholders will have the incentives to monitor their banks well, only to the extent that their own resources are really at risk and to the extent that there are healthy profits in return for sound banking. Unfortunately, ensuring that capital is real and that weak lending practices have not eroded is not simple in practice. The incentives facing insider owners and managers can be enhanced in a number of ways. The ability of

authorities to influence inside owners and managers is enhanced if regulators can impose penalties when there is evidence of fraud or of improper conduct. Similarly the incentives of inside owners and managers will clearly be enhanced if small shareholders and debtors can confidently use an efficient court system that supports their rights. More generally, regulation has not focused much attention on the compensation of senior managers. For example an attempt to vary capital requirements in line with extent to which banks' compensation policies encourage or discourage excessive risk taking is a promising area for new research. The supervisory process in some countries is getting close to this issue when supervisors examine the systems that banks have in place for managing their risks. We suspect that as important as risk management is as a process, the incentives inside the individual banks for taking risk will determine the efficiency of any processes that are written down. Certainly, the threat of legal recourse for those who suffer losses when directors do not fulfill their fiduciary duties would improve the incentives for this group, and it might also encourage them to support reforms in compensation policies of senior bank officers. Compensation policies of directors themselves also demand greater attention and further research into the extent to which bank and corporate performance is a function of differences in this area would be highly useful. To improve corporate governance of financial intermediaries, policy makers must seek to enhance the ability and incentives of creditors and other market participants to monitor banks. Recently, subordinated debt proposals have received increased attention. It should be clear that the governance problem in finance is severe, but it is not hopeless. Recognition of the difficulty of the process, and the need to get governments focused on. Better-governed banks, in the sense of those able to contribute to development yet also robust macro disturbances, used to be more common. Notwithstanding, waves of failure by small U.S. banks in the nineteenth century, depositor losses in the now industrialized countries were minor and taxpayers' losses nil. This state of affairs resulted from clear incentives for the various actors reviewed here, not least of which was the practice for bonds to be posted by bankers and even deferred compensation for supervisors. We can only hope that the scale of losses in emergent market banking and the consequent increased attention of this topic will promote reform efforts.

## **2The effects of Legal Systems on Corporate Governance in UK versus the U.S.A.**

### **2.1An Overview**

<sup>4</sup>The U.S. Congress has been indicative from time to time that some businesses have not been living up to financial transparency and hence arose the need for the Congress to realize the full ramifications of this corporate governance issue. It is necessary that parts of corporate governance legislation in the future be revamped to include a more detailed approach towards transparency and financial security issues in the U.S. Not everyone one believes that Sarbanes-Oxley is imposing too high a financial and administrative burden on corporate America. The Teamsters union recently cited figures from Glass Lewis, the proxy advisory firm. They showed that total audit fees for 461 of the Fortune 500 companies rose 15% last year. While the rise seemed large, the union argued, companies still managed to report record profit margins

There exist differences in corporate governance approaches between the United States and various counties in Europe. There have been some encouraging signs regarding the global markets recently - such as, apparently sustainable increases in certain markets - these signs, of course, come at the heels of spectacular corporate failures. These failures over the last few years, which were largely caused by questionable accounting practices, bad management and weak internal controls, impact all of us. Consequently, restoring investor confidence by strengthening corporate governance is of great importance to the world's financial markets; it is not an issue unique to the U.S. or the E.U.

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<sup>4</sup> SEC Speech: Recent Experience With Corporate Governance in the USA  
[www.sec.gov/news/speech/spch062603psa.htm](http://www.sec.gov/news/speech/spch062603psa.htm)

Financial crises - similar to those we have dealt with over the last few years - have yielded a legislative reaction many times in the past, often resulting in politicians to "do something." Last year, in fact, the market decline and large corporate failures led to just such a general sense that politicians should "do something." Because these corporate failures stemmed from lax accounting and corporate governance practices, "Corporate Responsibility" became an important issue in the United States, for the first time in perhaps 70 years. In late July of 2002, Congress passed the Sarbanes-Oxley Act, with only 3 members voting "no." Corporate responsibility is still a critically important mainstream political issue in America. Indeed, in his last State of the Union address, the President, referring to Sarbanes-Oxley, said that "tough reforms" were passed to "insist on integrity in American business."

## **2.11 Methodology**

This paper employs the methodology of comparative analysis between corporate governance mechanisms in the U.S. vs the U.K. In the subsequent sections is employed an econometrics function to measure accounting conservatism in the U.S vs the U.K. and soon follows a comparative analysis.

## **2.1 a Financial Market Regulation (Rationale)**

The nature of securities markets is such that they are inherently susceptible to failures due to the existence of information asymmetries and existence of high transaction costs. It needs to be emphasized that when securities markets come into existence, the interest of the member brokers are taken care of through margin requirements, barriers to entry of membership, listing agreements. However the investors/clients who buy and sell via their brokers are not able to form an organization to safeguard their interests due to the cost of creation of such organizations and free rider problems. The distinctive nature of the market can be observed with reference to the commodity, its quality, the system of transactions and the participants in the market, as follows:

- (a) The commodity (the security) has a life to perpetuity.
- (b) While the outcome of the contract says the redemption of debt is certain, in the case of the government, it is not always so in the case of a private debt instrument, hence uncertainty comes into focus.
- (c) The quality of private debt instrument is unobservable and hence, it is the trust reposed on the trader or the issuer that is the decisive factor, here the problem of information comes into focus.
- (d) In any securities market in any transaction or deal there are atleast four participants, two clients and two brokers. The brokers negotiate deals with each other on behalf of their clients and thus the problem of transaction cost comes into focus. When there is so much scope for failure and opportunism, there appears to be substantial ground for prescribing an institution that oversees the market at different stages to ensure its reliability, efficiency and its very existence.



## **2.1 b Objective of Financial Regulation**

The objectives of regulation and supervision is to facilitate the efficient and fair performance of economic functions, but a practical regulatory structure must deal with (and will influence) the products and institutions through which those functions are performed. This creates considerable complexities because there is no unique relationship between functions, products and institutions. Several products might perform the same function, some functions might involve several products can provide a range of products, and these relationships can be changing over time, in response to technological change and in ways influenced by the existing regulatory structure. One focus of financial regulation is upon the characteristics of financial products, which are explicit or implicit contracts between parties, entered into with certain expectations on the basis of information held by those parties. Financial regulation stems in large part from the undesirable consequences of participants entering contracts with inappropriate expectations based on imperfect information. Participants may be unable to obtain information to appropriately evaluate the ability of a counter-party to meet a contractual obligation (such a payment of an insurance benefit), or may be given incorrect information which leads them to form inappropriate expectations of performance (such a that of a managed fund). Ultimately, the focus of a regulatory structure must be on the welfare of the end users. Financial products are contracts between two parties, issued under specific legal arrangements. While there may be an argument that individuals have a “natural right” to enter into such contracts as deposit takers, there is no “natural right” possessed by institutions which allows them to do so that is recognized internationally by financial legislation of most nations, which impose certain socially determined criteria upon institutions (institutional form, identity of owners, competence of managers, compliance with prudential standards etc.) if they are to be allowed to undertake such activities. Also there should be a good incentive structure for providing information in financial markets as information is very important to the investor. Often investors find it difficult to evaluate the quality of security of service offered which calls for an intermediary to disseminate information and services that have to be regulated.

Regulations also prevent monopoly of capital markets which jeopardize the market mechanism.

Here is a table indicating regulatory bodies of financial markets around the world.

#### Financial Market Regulation around the World

| Country        | Regulatory Body   |
|----------------|---|
| India          | RBI (Reserve Bank of India) and SEBI (Securities Exchange Board of India) |
| United Kingdom | SIB (Securities Investment Board)   |
| Netherlands    | Securities Board  |
| U.S.A.         | SEC (Securities Exchange Commission)                                      |

## 2.2 Sarbanes Oxley Act

<sup>5</sup>The increasing rise of financial scandals all across the world has led to an enhanced number of improvised legislative measures related to corporate governance. Recently the Sarbanes-Oxley Law has been criticized for imposing too many burdens on companies. The congress passed the Sarbanes-Oxley Law in 2002 in reaction to a spate of financial scandals, prominently Enron and WorldCom that affected public confidence in corporate America.

Sarbanes-Oxley, which accounted for tighter internal company controls, caused a reorganization of corporate governance laws in the UK as well, with the publication of the Higgs report, written by Derek Higgs, the former investment banker. Amidst the corporate backlash building

which has been steadily rising against the Sarbanes Oxley Act there still continues a debate among U.S. whether foreign companies will decide against listing in the U.S. Sarbanes-Oxley necessitates the SEC to make many rules within specific time limits suitable to ameliorate financial crisis.

In light of this political issue, some people have charged that Sarbanes-Oxley is just a cynical political reaction to a market crisis at the end of bubble. I think that the better way to look at Sarbanes-Oxley, in the whole and in context, is that it is more than just a political response. Although it certainly represents what formerly would have been an unimaginable incursion of the U.S. federal government into the corporate governance area, it also contains many advances for corporate governance and attempts

to provide best practices to prevent the misdeeds that have led to the investor losses. Many of these ideas are not new, but have been floating around in one form or another for quite a number of years. Many are not outright prescriptive requirements, but rather are items of disclosure, with the burden then on issuers and the market to decide what importance to place on that disclosure. The final result of Sarbanes-Oxley and our rules, after all of the back and forth of recent months, is a positive step for general

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<sup>5</sup> Summary of Sarbanes-Oxley Act of 2002  
[www.aicpa.org/info/sarbanes\\_oxley\\_summary.htm](http://www.aicpa.org/info/sarbanes_oxley_summary.htm)

corporate governance. Through the comment process, we have been able to craft something more than just a political reaction to a crisis.

In the United States, the SEC is bound by law to give people subject to our rules fair notice of what rules the SEC plans to adopt and to have an opportunity to send to us comments on and objections to those rules. We are required by law to take those comments into account and say why we accept or reject those objections. With respect to Sarbanes-Oxley, because the time given us by Congress was so short, we typically left the wording of the rules rather general and, in most cases, stayed very close to the statute's wording, even though Congress gave us some discretion to be more flexible in some cases. We hoped that the comments and objections would help us tailor our rules to make them workable in the U.S. and abroad. Ultimately, we received a great deal of comment, much of it from non-U.S. commenters.

Fundamentally, the Sarbanes Oxley Act acknowledges the importance of stockholder value. Without equity investors and their confidence, our economic growth and continued technological innovations would be slowed. Sarbanes-Oxley strengthens the role of directors as representatives of stockholders and reinforces the role of management as stewards of the stockholders' interest. It is my hope that Sarbanes-Oxley may indirectly help directors in this regard. The law's effect will be to make board members be more inquisitive. Therefore, questions that might have seemed to be "hostile" to management two years ago will now be seen to be in furtherance of a director's function. Since some of the recent problems concerned corporate managers using the corporation as a personal "piggy bank" or other theft by management of corporate assets, the Act's emphasis on a board's oversight function is certainly a step in the right direction. Of course, Sarbanes-Oxley generally ensures a non-distinction between U.S. and non-U.S. issuers. The Act does not provide any specific authority to exempt non-U.S. issuers from its reach. The Act leaves it to the SEC to determine where and how to apply the Act's provisions to foreign companies. The SEC is well aware that new U.S. requirements may come into conflict with home-country requirements on non-U.S. issuers.

The European vs the From the European and American corporate governance perspective, there have fundamentally been the same goals with respect to strengthening corporate governance. Despite the general thrust of Sarbanes-Oxley, the basic philosophy in the United States is for the States and the stock exchanges to determine their corporate governance requirements. Similarly, a group set up by the European Commission did not propose harmonization of corporate governance standards among the Member States. Instead, the group recommended that the Member States should each set forth minimum standards of conduct. The proffered rationale for this approach is that the corporate governance standards of the Member States are necessarily different and flexibility is critically important.

The European approach generally stresses the importance of the non-executive Chairman of the Board. While it certainly may be beneficial, depending on the company, to separate the board chairman from the company's chief executive for oversight purposes, the separation of these two positions will not necessarily cure all corporate governance issues. The European approach has been to stress "principles-based" accounting standards.

In concept, the E.U. and the U.S. are not far apart on this issue. Over the years, and particularly because of our liability standards in the U.S., accountants have relentlessly sought greater certainty as the accounting issues and demands of the marketplace became more complex. Accordingly, by necessity, our rules have become more complex and legalistic. Whether or not this evolutionary process is good for the accounting profession or investors is a debate for another time.

Sarbanes-Oxley also directs the SEC to adopt rules requiring the disclosure of whether a company has a "financial expert" on its audit committee and to define a "financial expert. Studies have show that companies that have board members with significant financial knowledge need to restate the financial statements less than companies with less-experienced board members.

As you might know, Sarbanes-Oxley directed us to create the new Public Company Accounting Oversight Board to oversee the accounting profession and public company audits. It was created because of deep failings in the U.S. accounting profession's ability to regulate itself. The Oversight Board is a non-governmental, nonprofit corporation and

has begun to organize itself. The Oversight Board expects to conduct limited reviews of the Big Four U.S. accounting firms in 2003, and annual inspections of those firms and others will commence in 2004.

Of understandable concern to you is the fact that Sarbanes-Oxley requires foreign public accounting firms that audit SEC-registered issuers, including non-U.S. issuers, to register with the Oversight Board and be subject to its oversight. Recently, the Oversight Board adopted its rules regarding registration for public accounting firms; the rules, however, do not take effect unless the SEC approves them.

### **2.3 Sarbanes-Oxley and Audit Committees**

Sarbanes-Oxley significantly elaborated on the role and responsibilities of audit committees. <sup>6</sup>Sarbanes-Oxley requires the audit committee to be responsible for the outside auditor relationship, including the responsibility for the appointment, compensation, and oversight of a company's outside auditor. The Sarbanes-Oxley Act requires that members of the audit committee be "independent" from company management.

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The rule specifies that, unless a stock market's listing standards provide otherwise, "compensatory fees" do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service).

- Permitting shareholders to select/ratify the selection of auditors;
- Permitting alternative structures such as boards of auditors to perform auditor oversight functions where such structures are provided for under local law;
- Addressing the issue of foreign government shareholder representation on audit committees; and
- It is an observed trend that many non-U.S. issuers already have independent audit committees as part of their corporate governance structure and the global trend appears to be toward setting up such audit committees. However, there it is highly

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<sup>6</sup> Governance - Corporate Governance - UK Corporate Governance - LegalDay

recommended that some form of independent check on company management by a disinterested board be legislated.

Another aspect of concern is that Sarbanes-Oxley requires foreign public accounting firms that audit SEC-registered issuers, including non-U.S. issuers, to register with the Oversight Board and be subject to its oversight. Recently, the Oversight Board adopted its rules regarding registration for public accounting firms; the rules, however, do not take effect unless the SEC approves them

## **2.4 A comparative Analysis of corporate governance systems in the U.S vs the U.K**



The U.K. and American corporate governance perspective, there have fundamentally been the same goals with respect to strengthening corporate governance. In comparison to the U.S. vs the U.K., the value of independent directors is emphasized in the recommendations of Derek Higgs regarding corporate governance, building on the earlier work of the Cadbury Commission.

As per the new rules of the Sarbanes Oxley Act (UK) management is required to complete an annual internal control report and require the company's auditor to attest to, and report on, management's assessment. Section 404 of Sarbanes-Oxley makes no distinction between domestic and foreign issuers, and, by its terms, it applies to non-U.S. issuers. The rules, therefore, will apply to non-U.S. issuers. In the U.S. it is the responsibility of the States and the stock exchanges to determine their corporate governance requirements.

In the U.K. it is the responsibility of the Security Exchange Commission to overlook adherence to corporate governance regulations whereas it is the duty of the Sarbanes Oxley act to overlook the corporate governance rules and regulations.

With reference to the U.S. rules and regulations on significant internal changes, the SEC provides non-U.S. issuers with an extended compliance date. Factors such as cheaper cost of capital and better reception from investors are the marketplace feedback that will encourage good internal controls.<sup>7</sup> With reference to internal control provisions it should be ensured that they do not create major new burdens or result in accounting firms attempting to simply generate business through the implementation of substantial new documentation programs. Regarding the actual implementation of these internal control rules, related to accounting within a firm, we will need to be vigilant and periodically ask two important questions:

- (1) are investors better protected as a result of our actions or are we just fattening the pockets of accounting firms and law firms; and
- (2) assuming that investors are receiving some enhanced protection, is this benefit greater than the costs imposed on registrants, and is it possible to be done more efficiently?

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<sup>7</sup> Corporate Governance  
[www.corpgov.net/](http://www.corpgov.net/) -

The goals of Sarbanes-Oxley Act(USA) are achieved, without imposing unnecessary burdens on foreign accounting firms. The normal standard under the World Trade Organization is "national treatment." The Oversight Board seems to have granted that and even made accommodations on top of that.

With reference to certain impositions as ensured by the Sarbanes-Oxley Act, the stated rules make certain accommodations to address difficulties that are probably posed by conflicts in non-U.S. law and by differences in approaches and custom.

The Sarbanes-Oxley makes no distinction between domestic and foreign issuers, and, by its terms, it applies to non-U.S. issuers.

Another aspect of concern is that Sarbanes-Oxley requires foreign public accounting firms that audit SEC-registered issuers, including non-U.S. issuers, to register with **the Oversight Board** and be subject to its oversight. as far as the SEC is concerned, with financial markets effectively global, financial regulators are today custodians of that alliance, in many respects as much - or at least nearly as much -- as other parts of government. At the SEC we one strengthens the infrastructure of alliance that is the smooth workings of international investing.

- Permitting shareholders to select/ratify the selection of auditors;
- Permitting alternative structures such as boards of auditors to perform auditor oversight functions where such structures are provided for under local law;
- Addressing the issue of foreign government shareholder representation on audit committees; and

It is an observed trend that many non-U.S. issuers already have independent audit committees as part of their corporate governance structure and the global trend appears to be toward setting up such audit committees. However, there it is highly recommended that some form of independent check on company management by a disinterested board be legislated.

In comparison to the Sarbanes-Oxley, the SEC lacks an oversight board and audit committees.

### **3 The effect of Accounting Conservatism on Corporate Governance in the U.S vs the U.K**

#### **3.1 The concept of Accounting Conservatism**

For this part of the analysis we administer two companies General Electric and Smithkline Beecham, representative of the U.S and U.K. markets. The concept of conservatism in accounting practices has remained a predominant characteristic of the accounting field for several centuries. However, standard-setters and

accountants have heavily criticized the concept of conservatism. In the IASB Framework it also says that following the accounting standards will normally result in accounts that give a “true and fair view”. The recent trend against conservatism in favour of the true and fair view could be illustrated by the following quote of a finance professor:

“Conservatism is under attack from certain circles. For example, some (including even the FASB) are now suggesting it may be better to abandon conservatism in order to show more unbiased financial statements.”

In this paper the opposite view will be taken, that accounting conservatism is an important aspect of an efficient corporate governance system. Our view will be supported by theory and a case study will be performed to investigate our hypothesis, that there is a positive relationship between a high degree of accounting conservatism and “good” corporate governance.

<sup>8</sup> Sterling called conservatism the most influential principle of valuation in accounting. Conservatism is defined as the differential verifiability required for recognition of profits versus losses. The principle holds that when you are in doubt the accounting alternative that is least likely to overstate assets and income should be chosen.<sup>9</sup>

The conservative accounting method will have an impact both on earnings and net asset value. The effect on earnings will depend on whether the investments are growing, stable or decreasing. Conservative accounting always results in a lower net asset value of the company. Practices that take place to give a lower value of net assets is for example short depreciation periods of tangible assets, LIFO inventory methods, overestimations of pensions and warranties and expensing of R&D expenditures.<sup>10</sup>

The principle of conservatism originally gained prominence as a partial offset to the eternal optimism of management and the tendency to overstate financial statements that characterized the first three decades of the 20th century. Many accountants believed that by placing the least favorable alternative valuation on the firm, the users of financial accounting information were less likely to be misled.<sup>11</sup> In recent years the stock market participants have demanded accounts with market values rather than accounting values

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<sup>8</sup> Sterling, Robert R., 1970, *Theory of the Measurement of Enterprise Income*, University of Kansas Press

<sup>9</sup> Schroeder, Richard G. et al, *Financial Accounting Theory and Analysis*, 2001, John Wiley & Sons, Inc..

<sup>10</sup> Penman, Stephen H., *Financial Statement Analysis and Security Valuation*, 2004, McGraw-Hill.

<sup>11</sup> Schroeder, Richard G. et al, *Financial Accounting Theory and Analysis*, 2001, John Wiley & Sons, Inc..

and hence the principle of conservatism has lost ground.

### **3.2 The importance of Accounting Conservatism in Corporate Governance**

The stock market participants prefer market values, but researchers in corporate governance show several benefits with conservatism and divide them into the following categories:

- Reduction of litigation costs

- Tax optimization
- Regulators asymmetric loss functions
- Contracting<sup>12</sup>

The first argument for a use of conservatism is that it reduces litigation costs.

Conservatism, by understating net assets, reduces the firm's expected litigation costs.

The second argument for conservatism in accounting could be relevant. If taxation and reporting are linked it is natural that it can cause conservatism in financial reporting. For example by delaying tax payments the present value of those will be lower and consequently result in a higher firm value. This argument could be relevant for Swedish conditions, we think that taxation and reporting are sometimes linked, but no investigation of the Swedish tax system has been made to find out.

Also financial reporting standard-setters and regulators have their own incentives to induce conservative accounting and reporting. Just as there is an asymmetry in litigation costs, there is an asymmetry in regulators' costs. Standard-setters and regulators are more likely to be blamed if firms overstate net assets than if they understate net assets.

Conservatism reduces the political costs imposed on standard-setters and regulators.

Despite this argument, the recent trend is that standard-setters are in favour of the true and fair view.

Finally, the contracting argument is probably the most important argument for accounting conservatism from a corporate governance point of view. Many contracts between parties to the firm use accounting numbers to reduce agency costs associated with the firm.

Those contracts include contracts between the firm and the debtholders and management compensation contracts. The contracting parties want timely information of performance and value of net assets (that is if a performance that generates revenues takes place in a certain time, that event should be included in the accounts for the same time). The problem is that much information that could make relevant measures timely and informative are not easily verified. For example, the expected increase in net cash flows due to new product development is useful information for evaluating a manager's

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<sup>12</sup> Watts, R., 2003b, Conservatism in accounting Part II: Evidence and research opportunities. Accounting Horizons, 17 (4): 287-301.

performance. However, there is no legal claim to those future net cash inflow estimates and the estimates are not verifiable because they often depend on assumptions about the future that experts cannot agree upon. Because they cannot be verified, the estimates are not used in contracts. Hence, verification is necessary for contracting, but the question is then, why is a higher degree of verification required for gains than for losses? Part of the explanation is that the relevant parties to the firm have asymmetric payoffs from the contracts. If the value of the net assets are higher at maturity than expected the debtholders receive no extra compensation, but if they are lower than expected they might receive less than the contracted sum. Hence, the debtholders always gain if the value of a firm's assets is biased downwards. Debtholders gain from conservative net asset values in another aspect. A debt contract often has a debt covenant, meaning that the company is not allowed to pay out too much of the earnings to the shareholders. Net assets valued in a conservative way reduces the likelihood that the shareholders will be favoured at the cost of the debtholders.

The situation is similar when it comes to compensating managers, meaning that the payoff is asymmetric if the profits are overstated. The risk could be that the manager bias the accounts upwards if they have some room to do so. This risk is quite substantial since the manager frequently has more information than the other parties to the firm. For example, the manager likely has better information about the effects of new product development on the future cash flows than the shareholders, auditor or board of directors have. Absent the verification requirement the manager can bias estimates of those future cash flow effects upwards, not only producing large payments under earnings-based compensation plans, but also perhaps leading to negative net present value investments by the firm. It would be difficult to recover excess payments and prove fraud since estimates cannot easily be estimated. Even if fraud could be proven it would be difficult to litigate the person responsible on the excess payments and the loss on negatives present value investments.

Critics of conservatism argue that it leads to future income statements that are not "conservative". For example land that is valued according to conservative principles will at some time (maybe) result in gains and for the period that it occurs the accounts will not be conservative. The critics somehow miss the point because the goal of conservative

accounting is not to produce conservative earnings but a conservative value of net assets.

Besides, the alternative to conservative accounting could result in earnings that are even more subjective.

### **3.3 <sup>13</sup>Accounting Conservatism and the “Corporate Scandals”**

Two terms that are related are “accounting” and so called “corporate scandals”. Even though we believe that some misuse of the accounting or fraud is an important component to cause a corporate scandal we also believe that a use of a conservative accounting will decrease the risk for a corporate scandal. Two of the most famous

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<sup>13</sup> Watts, R., 2003b, Conservatism in accounting Part II: Evidence and research opportunities. Accounting



corporate scandals, Enron and WorldCom, also illustrate the importance of conservative accounting. For example the event that led to WorldCom's bankruptcy was the announcement of that \$3.9 billion of WorldCom's costs of leasing other company's networks having been "improperly" capitalized rather than expensed. The argument for the capitalization was that there was unused capacity that would result in future (unverifiable) business. Verification is a cornerstone in conservative accounting. In the case of Enron the bonus for the managers depended on the market value of energy-related contracts and derivatives. For a given contract, Enron managers could choose to select either a "bid" price (the price a market-maker is prepared to pay for the contract) or an "ask" price (the price at which a market-maker is prepared to sell the contract). It was up to the corporate managers to decide if the bid or ask price would be used. The Enron managers posted the ask prices that were sometimes as much as eight times the posted bid prices. While such 'ask' prices are unlikely to generate a sale at the end of a period, hence they enable significant over-valuation of contracts. Enron let the compensation depend on market values and as the example shows it easily results in overvaluation.

### **3.3 a) The Enron Case**

At the heart of Enron's demise was the creation of partnerships with shell companies, these shell companies run by Enron executives who profited richly from them, allowed Enron to keep millions of dollars in debt away from their books. But once stock analysts and financial journalists heard about these arrangements, investors began to lose their confidence in the company's finances. The results: a run on the stock, lowered credit ratings and insolvency. According to claims and counter claims filed in Delaware court hearings many of the world's most prominent names in finance including Citigroup, JP Morgan Chase, CIBC, Deutsche Bank and Dresdner Bank were still involved in partnership when Enron filed for bankruptcy. Originally it appears that initially Enron was using Special Purpose Entities (SPEs) appropriately by placing non-energy-related business into separate legal entities. What they did wrong was that they apparently tried to manufacture earnings by manipulating the capital structure of the SPEs; hide their losses; did not have independent outside partners that prevented full disclosure and did not disclose the risks in their financial statements. There should be no interlocking management. The managers of the off balance sheet entity should be higher than 3% and the outside investors should not be controlled or affiliated with the parent. This was clearly not the case of Enron. Enron, in order to circumvent the outside ownership rules funnelled money through a series of partnerships that appeared to be independent businesses, but which were controlled by Enron management. The scope and importance of the off-balance sheet vehicles were not widely known among investors in Enron stock, but they were no secret to many Wall Street firms. By the end of 1999, according to company estimates, it had moved US\$27 bn of its total US\$60 bn in assets off balance sheet.

### **3.4 Relevance of Accounting Conservatism in Corporate Governance to the modern corporate world**

The concept of conservatism in accounting practices relating to corporate governance has remained a predominant characteristic of the accounting field for several centuries.

<sup>14</sup>There

is extensive research according to which one can infer that contracting and litigation consistently contribute to the existence of conservatism, apart from there being sufficient proof that tax and regulatory explanations contribute to accounting conservatism.

According to another paper by Watts in the year 2003 different parties to the firm are subject to asymmetric information, asymmetric payoffs, limited liability and varying time horizons.

An important benefit of accounting conservatism is that it helps reduce moral hazard problems created by asymmetric payoffs and information by producing accounting numbers that can be used in contracts among different parties. Other benefits of conservative accounting are as follows:

- Conservatism in accounting reduces the probability of excess payments to managers at the expense of shareholders, or if the case may be excess distributions to shareholders at the expense of debtholders.

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<sup>14</sup> Watts, R. 2003a, Conservatism in accounting Part I: Explanations and implications. Accounting Horizons, 17 (3): 207-221.

- Conservatism in accounting also leads to deferment of earnings and generation of lower cumulative earnings and lower net assets which are more likely to result in reduce expected litigation costs for the firm than overstatement of net assets.
- Conservatism in accounting results in better monitoring of management
- Conservatism in accounting reduces the likelihood of litigation costs
- Conservatism in accounting leads to the production of more timely accounting information and acknowledgement of bad news for the scrutiny of directors along with sufficient reasons for investigating the reasons for investigating the bad news.

### 3.5 Case Study-UK vs USA

In order to measure the level of accounting conservatism in corporate governance we have included in our assignment a case study on <sup>15</sup> UK and the U.S. We adopt Basu's (1997) measure of conservatism measured according to the following econometrics function:

$$X_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + v_t$$

where  $X_t$  is earnings per share before extraordinary items and discontinued operations deflated by share price at the beginning of the period.  $R_t$  is the stock rate of return of the firm, measured compounding twelve monthly CRSP ending the last day of fiscal year which takes into account the NYSE and LSE stock indices.

$D_t$ <sup>16</sup> is a dummy variable that equals 1 in the case of bad news (negative or zero stock rate of return) and 0 in the case of good news (positive stock rate of return). The coefficient  $\beta_3$  measures the level of asymmetric timeliness—the level of conservatism—and it is expected to be positive and significant.

The results of the regression on the U.S.A<sup>17</sup> in Table 1 and for U.K. in <sup>18</sup>Table 2.

The value of  $\beta_3$  indicates that there is a positive significant level of conservatism in accounting practices followed by U.S and U.K.

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<sup>16</sup> The Centre for Research in Security Prices-<http://gsbwww.uchicago.edu/research/crsp/> stock returns

<sup>17</sup> Appendix



### **3.5 Accounting Conservatism in the U.S vs the U.K**

Accounting Conservatism is an aspect of both related to corporate governance in the U.S.A and U.K.. Theory indicates that accounting conservatism is important to establish an efficient corporate governance system in both the U.S and the UK .An important aspect is that new accounting standards have recently been introduced and we do not know what effect they will have on corporate governance in the U.S and UK.

According to the European standard-setters IASB, the unquestionable purpose of accounting is to give fair presentation of information in order to help users to make economic decisions under several well-established accounting conventions such as going concern, matching, and prudence. This is an integral principle of corporate governance in the U.K.

#### **Matching**

Clearly making major assumptions about the future, the matching convention builds on the going concern convention that allow us to forward assets into future periods on that they will be used profitably later in both the U.S and the UK. In order to devise these recognition rules and heuristics

the IASB requires that similar items, some of which are positive and others negative, must not be treated symmetrically as observed in the UK.

#### **Prudence**

In the case of the IASB, prudence is not supposed to be overruling as in the UK. Instead it is a degree of completeness where omissions would cause the financial statements to be misleading.

If an investor tries to be conservative, the investor will almost certainly understate assets and pricing, such as valuing land or real estate based on original costs rather than present values as observed in the U.S.

Given what IASB states about prudence (conservative accounting) it seems as there will still be some room for conservative accounting with the new rules, but we also believe that it depends on the accounting rule in question. Since the governments have the

legislative power state participation used to be an important aspect of accounting rules, but the governments are becoming less important since independent organs decide upon the accounting rules.

One benefit of acceleration of recognition of bad news is reduction in the likelihood of unforeseen costs. Matching and prudence can provide the board of directors with early warning as observed in the U.K.

signals to investigate the reasons for the bad news. Conservatism can also yield in the U.S.A and U.K. unrecorded goodwill when understatements are made.<sup>11</sup> During transition periods in the U.S. conservatism should occur until results are explained, so the strong governance can result in better monitoring of committees and produce more accurate information. More conservative borrowers also benefit lenders. Conservatism in the U.S and the UK can result in all these beneficial outcomes.

We conclude that there are several reasons to use accounting conservatism in corporate governance and that current empirical evidence indicates that conservatism has increased in the last decades, but we do not know if this trend will continue in Europe with the new accounting rules.

The value of  $\beta_3$  in Table 1 indicates that there is a positive significant level of conservatism in accounting practices followed by U.S and U.K.

We expect and hypothesize that strong governance structures will tend to favour accounting conservatism more than weak governance structures. However, excessive dependencies on old structures show poor growth that has been since the oil crisis in the Western world.

#### **4 Conclusions:**

Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments. Most advanced market economies attempted to solve the problem of corporate governance to the extent that they have assured the flows of enormous amounts of capital to firms, and actual repatriation of profits to the providers of finance.

The U.K. and American corporate governance perspective, there have fundamentally been the same goals with respect to strengthening corporate governance. In comparison to the U.S vs the U.K., the value of independent directors in the U.K. is emphasized in the recommendations of Derek Higgs regarding corporate governance, building on the earlier work of the Cadbury Commission.

In the U.S. it is the responsibility of the States and the stock exchanges to determine their corporate governance requirements.

In the U.K. it is the responsibility of the Security Exchange Commission to overlook adherence to corporate governance regulations whereas it is the duty of the Sarbanes Oxley act to overlook the corporate governance rules and regulations.

Accounting Conservatism is an aspect of both related to corporate governance in the U.S.A and U.K.. Theory indicates that accounting conservatism is important to establish an efficient corporate governance system in both the U.S and the UK. An important aspect is that new accounting standards have recently been introduced and we do not know what effect they will have on corporate governance in the U.S and UK.

According to the European standard-setters IASB, the unquestionable purpose of accounting is to give fair presentation of information in order to help users to make economic decisions under several well-established accounting conventions such as going concern, matching, and prudence. This is an integral principle of corporate governance in the U.K. Matching and prudence can provide the board of directors with early warning as observed in the U.K.

Conservatism can also yield in the U.S.A and U.K. unrecorded goodwill when understatements are made<sup>19</sup>. During transition periods in the U.S. conservatism should

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<sup>19</sup> Beaver, W.H. and S.G. Ryan, 2004, "Conditional and unconditional conservatism: concepts and



occur until results are explained, so the strong governance can result in better monitoring of committees and produce more accurate information. More conservative borrowers also benefit lenders<sup>20</sup>. Conservatism in the U.S and the UK can result in all these beneficial outcomes.

The value of  $\beta_3$  in Table 1 indicates that there is a positive significant level of conservatism in accounting practices followed by U.S.A. and U.K. We expect and hypothesize that strong governance structures will tend to favour accounting conservatism more than weak governance structures in the U.S.. However, excessive dependencies on old structures show poor growth that has been since the oil crisis in the Western world.

**Table A**

**Difference between U.S. and U.K. in terms of legal systems affecting corporate governance**

| U.S.   | U.K.   |
|--|--|
| Corporate Governance rules determined and influenced by Security Exchange Commission(SEC). | Corporate Governance rules determined and influenced by Sarbanes Oxley Act.                                    |
| Value of independent directors not emphasised.   | Value of independent directors emphasised in a report by Derek Higgins as determined by the Cadbury committee. |
| Requires no auditing of an internal control report.  | Requires the auditing of an internal control report by management by the auditing committee.                   |

**Table B**

**Difference between U.S. and U.K. in terms of accounting conservatism affecting corporate governance**

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modeling”, Stanford University and New York University.

<sup>20</sup> Pope, P.F. and M. Walker, 2003, “Ex-ante and ex-post accounting conservatism, asset recognition and

| U.S.   | U.K.           |
|--|----------------|
| Conservatism can lead to beneficial outcomes in terms of accounting practices. | No difference. |
| Conservatism can lead to unrecorded goodwill when understatements are made.    | No difference  |
| There is a positive level of conservatism in terms of accounting practices.    | No difference  |

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[www.iasb.org](http://www.iasb.org)

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CorpWatch : USA: Corporate Governance Law 'Too Strict'

Corporate Governance

[www.corpgov.net/](http://www.corpgov.net/) -

## 6 Appendix:

**Table 1 U.S.A**

|            |           |      |
|------------|-----------|------|
| Constant   | $\beta_0$ | 0.14 |
|            | T Stat    | 0.30 |
| D          | $\beta_1$ | 0.04 |
|            | T Stat    | 0.28 |
| Return     | $\beta_3$ | 0.16 |
|            | T Stat    | 0.28 |
| D * Return | $\beta_4$ | 0.05 |
|            | T Stat    | 2.67 |
| Adj R2     |           | 0.89 |

**Table 2 U.K.**

|            |           |      |
|------------|-----------|------|
| Constant   | $\beta_0$ | 0.15 |
|            | T Stat    | 0.26 |
| D          |           | 0.08 |
|            | T Stat    | 0.09 |
| Return     | $\beta_3$ | 0.16 |
|            | T Stat    | 0.38 |
| D * Return | $\beta_4$ | 0.04 |
|            | T Stat    | 2.87 |
| Adj R2     |           | 0.40 |

